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A DuPont Analysis on Insurance Sector of South Asian Region

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ABSTRACT

This research is to examine that most of the time investors do not prefer to highly profitable companies. We investigate the DuPont equation on insurance sector of South Asian region. Through DuPont analysis we see which types of companies are most fruitful for investor. We are using two method of ranking, first one is base on profit (Net income) and second one is base on DuPont equation. After that we see impact of independent variables (Return on asset & financial leverage) on dependent variable (return on equity) by regression analysis. The result shows that the ranking according to DuPont method are more reliable for investors as compare to profit (net income). The finding of this paper is that investor should work on effort method as judge against to effect method.

Keywords- Net income, Profit Margin, Asset Turnover, Financial Leverage, ROS, ROA, ROE and DuPont technique.

1. INTRODUCTION

Now-a-day mostly investors work on DuPont equation because investors can see a comprehensible picture of firm performance from the help of DuPont analysis. DuPont model basically tells about the comparisons of return in similar firms or industries through ROE. Donaldson Brown was the founder of the DuPont equation in 1914. The mechanism of DuPont equation measure ROE through profit margin, asset turnover and financial leverage. In this model firm Profit margin describes working efficiency, asset turnover describe utilization of asset and financial leverage describe equity multiplier.

A sole idea of this research is which types of companies are most fruitful for investor. For this work we rank companies firstly on Net income and secondly on DuPont model (ROE). DuPont equation applies on insurance sector of South Asian region countries namely; India, Pakistan, Bangladesh and Sri Lanka. The lots of past studies show that the magnitude of DuPont equation (Darmika, 2008; Angell and Brewer, 2003; Liesz, 2004; little et al., 2009; Herciu et al., 2011).

The basic purpose of this paper is to examine that a lot of times investors do not prefer to highly profitable companies in the course of DuPont technique. The mostly past researchers have worked on two components of DuPont analysis namely; profit margin and asset turnover¹ on the bases of ROA. Some researchers have worked on the bases of three components of DuPont analysis on the bases of ROE². You can comparisons of firms through DuPont analysis in almost every industry (IT, Textile, Automobile, Agriculture and FMCG) but there is no this type of work on insurance sector. This study analysis the insurance sector of South Asian region through DuPont analysis and investigate that which types of companies are most fruitful for investor.

We apply DuPont equation on Insurance sector of south Asian countries (India, Pakistan, Srilanka and Bangladesh). Insurance sector is one of the most important financial institutions. Insurance sector is equally important both for social and economic development. We diminish threat and ambiguity from the help of insurance institution. Insurance sector also participate very important role in under development countries. The contribution of insurance sector is 1.41 % in

¹ Darmika (2008), Little et al. (2009)

² Mihaela, H., Claudia, O., and Lucian, B. (2011), Mark, T.S. (2008)

GDP of Pakistan. The contribution of insurance sector is 0.4 % in GDP of India. The contribution of insurance sector is 1.5 % in GDP of Srilanka. The contribution of insurance sector is 0.57 % in GDP of Bangladesh.

2. LITERATURE REVIEW

There are two components of literature review, first one is Theoretical background and second one is Empirical studies. We will describe the different theories of different author about DuPont equation in Theoretical background. In empirical studies we will describe previous research of DuPont equation on the bases of topics, variables, statistical techniques, result and finding.

2.1 Theoretical Background

The ROE³ tell us the performance of firm. In DuPont model we divide return of equity for better position or understanding. This break is generally referred to DuPont analysis. First, ROE ratio can subsist divided into two ratios that we have discussed_ net profit margin and equity turnover. In this equation net sale multiplied and divided on both side of equation. In this equation we used end year figure slightly than average of beginning and ending year. This equation tell ROE equivalent the equity and profit margin, if an organization want to increase its ROE, so equity is another source for this organization.

As noted previously, equity turnover play important role in capital structure. When equity turnover increase so higher debt of capital involve.

Similar to the prior breakdown, this is distinctiveness because total asset have been divided and multiplied from equity turnover. The equation shows that the equity turnover is equal to asset turnover. Specifically, the leverage ratio⁴ tells us total asset invested on debt. Equity is another tool for investment. When, asset to equity ratio is high so, the debt to equity ratio is high. Likewise, a total asset-equity ratio of 3 indicates only 1/3 of total asset was invested on equity and 2/3 was invested on debt. This financial leverage be also referred to as the financial leverage multiplier; because the starting ratios identical return on total asset and return of total asset times

³According to Reilly & Brown, the writer of Investment Analysis and Portfolio Management

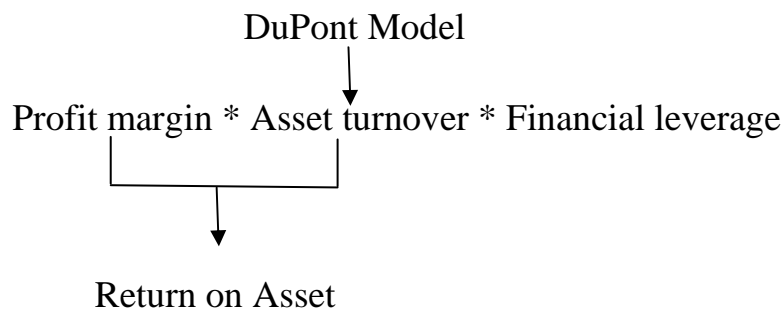
⁴ Leverage ratio is also known as Debt to Equity ratio. If you add one in leverage ratio, this will convert into financial leverage.

the financial leverage multiplies generation return of equity. Combining these two crashes, we see that a firm return on equity is collected of three ratios.

The DuPont Company⁵ of US has successfully worked on this system. This system is helpful for analysis because information base on financial statement. Now a day's many firms has adopted this system. DuPont charts are the return on assets (ROA), defined net profit margin (NPM) and the total asset turnover ratio (TATR).

This breakdown tells us how return of asset impact on profit margin and asset turnover. You can see discussion of profit margin on upper side. The upper side tell us when we will reduce cost so net profit margin will improve. The lower side shows the explanation of asset turnover. This side tells us how firm can efficiently utilize its resources. From the help of return of equity you can further divide the DuPont analysis.

The third component on the right side called the equity multiplier is equal to: $1 + \text{debt/Equity}$ ⁶. The extension of DuPont chart as applied to Horizon Limited. You can better understand DuPont analysis from the help of this diagram.



Source: Prasannna Chandra

⁵ Prasannna Chandra, the Indian author of Investment Analysis and Portfolio Management.

⁶ Equity multiplier is another name of financial leverage. You can better understand the help of last equation.

2.2 Empirical Studies

Conrad (1984) investigated that return of equity or capital is equally important for nonprofit organization by using data of American Hospital Association from 1971-1977. Return on equity, competitive pricing approach and CAPM are considered. The result shows that reasonable returns on equity are necessary for nonprofit organization. Ghosh & Jain (1998) investigated boost in leverage be the reason of merger by using almost 250 mergers accomplished linking for the year of 1978-1987. Mergers; Financial leverage; Debt capacity are considered. Regression techniques have been used. The result shows that financial leverage of combine firm is high as compare to other.

Liesz (1999) investigated that the failure of small business is always a debate topic by using the financial statement of small firms. OPM, Equity turnover, cost ratio, structure ratio, and tax ratio are considered. DuPont techniques have been used. The result shows that poor financial planning and control rank are the reason of business failure. Philip et al. (2007) investigated that the performance of retail firms by using data of 50 retail firms. Profit margin, asset turnover, RONO, 50 retail firms are considered. ANOVA techniques have been used. The result shows that differentiation firms (profit margin is high and asset turnover is low) outperform cost leadership firm (profit is low and asset turnover is high).

Soliman (2008) investigated that asset turnover and profit margin are two main component of DuPont model by using financial analysis from the help of annual data. Financial statement analysis, DuPont model, and analyst forecast are considered. Regression techniques have been used. The result shows that the relationship between DuPont components is useful for stock return and analyst forecast revision. Darmika (2008) investigated that this study examine the comparison of firms which successfully invest in I.T as compare to firms which cannot successfully invest in I.T by using Swa Sembada and Warta Ekonomi magazine, stock market website and library information. Information technologies, Competitive advantage, DuPont Analysis, Return on assets are considered. Normality test techniques have been used. The result show that which firms successfully invest in I.T have far better performance as compare to rival firm.

Weeden and Langemeier (2008) investigated that the performances of different age farmers by using continuous data 2002 to 2006. Profit margin, asset turnover, financial leverage, ROE and capital gain are considered. T test techniques have been used. The result show that performance of older farmer was lowest than younger farmers. Little et al. (2009) investigated that is to compare the performance of retail firms by using to select 111 retail firms for years 2006-2009. Retail strategy, recession, differentiation, cost leadership, DuPont methods are considered. ANOVA techniques have been used. The result shows that differentiation firms (profit margin is high and asset turnover is low) outperform cost leadership firm (profit is low and asset turnover is high)

Moss et al. (2009) investigated that the effect of ROE on Agricultural by using USDA data for 1960 to 2004. Profit margin, asset turnover and financial leverage are considered. Correlation techniques have been used. The result shows that ROE effect of regional and national level. Escudero (2009) investigated that the relation between CEO salary and firm performance by using 210 CEO's salary data from 1990. Firm performance, CEO's salary and ROE are considered. Least square method has been used. The result shows that there is weak relationship between CEO's salary and performance. Collins et al. (2010) investigated that the influence of profit margin on firm business model in the US industry by using data from US airlines. Profit margin pushiness, business models, U.S.A aviation business are considered. Regression techniques have been used. The result shows that low cost carrier is more profitable than network carrier.

Selvarasu et al. (2010) investigated those strategies for humanizing the performance of a medium volume Indian Apparel Company by using annual and financial report of 2007. ROE, profit margin, asset turnover and financial leverage are considered. SPM techniques have been used. The result show that company success depend upon two things increase sale and decrease expense and cash. Herciu et al. (2011) investigated that most profitable companies are not necessary most attractive for investors by using annual reports of 20 companies of 2009. Profit margin, ROE, ROS, ROA, financial leverage and DuPont model are considered. DuPont mode 1 techniques have been used. The result is showing that the ranking rely on this factors like ROE, ROS, ROA and financial leverage.

Raza et al. (2011) investigated that strength of CAPM by using data of three eighty seven companies. Risk, CAPM and Decision making are considered. Pair t- test techniques is use. The result shows that CAPM is useful for short term investment. The finding of this research paper is, CAPM should use for short term investment decision. Abdoli et al. (2011) investigated that about the comparison DEA and DuPont model by using 13 financial ratios. AHP, DEA and DuPont model are considered. Correlation techniques have been used. The result shows that there is weak correlation between DEA and DuPont model.

Alaghi (2011) investigated that effect of financial leverage on systematic risk by using data of listed companies of Tehran stock exchange. Financial leverage, capital structure, systematic risk, operating leverage, earnings per share (EPS), and earnings before interest and taxes (EBIT) are considered. Regression techniques have been used. The result shows that financial leverage on systematic risk.

3. METHODOLOGY

DuPont model basically tell about the comparisons of return in similar firms or industries through ROE. In this model firm Profit margin describes working efficiency, asset turnover describe utilization of asset and financial leverage describe equity multiplier. The main hypothesis of this research is that the higher profitable companies are not most fruitful for investor. For this purpose we use DuPont analysis on insurance sector of South Asia region. Firstly we rank insurance sector on Net income and secondly we rank insurance sector on ROE. We analyze the relationships between one dependent variable (Return on Equity) and three independent variables (Profit margin, Asset turnover and financial leverage) from the help of multiple Regression model. The model of this research is

$$ROE = \alpha + \beta_1(ROA) + \beta_2(FL) + \varepsilon$$

The independent variables of this research are ROA = Return on Asset (Profit margin * Asset turnover), and FL = Financial leverage. The dependent variable of this research is ROE = Return on Equity. So, α is Constant, β_1 & β_2 is Standardized Coefficient and ε is Estimate Error. For accurate measurement and superior yield the data I have calculated in ratio.

All secondary information will be taken from website of insurance companies and Insurance association of South Asian countries. The 2010, 2009 and 2008 annual reports⁷ of Insurance sector of South Asia region is use in this study. Quantitative analysis data method is exercise. Investigate the data by mean of correlation technique and regression technique.

4. ESTIMATION AND RESULTS

The main hypothesis of this research is that the higher profitable companies are not most fruitful for investor. For this purpose we use DuPont analysis on insurance sector of South Asian countries. Firstly we rank insurance sector on Net income and secondly we rank insurance sector on ROE.

The Table 1⁸ tells us the ranking of insurance sectors according to Net Income. IGI Insurance gets first position in thirty one insurance companies of Pakistan. The net income of IGI Insurance is 836556 million. EFU General Insurance gets loss last position according to net income. The net loss of EFU General Insurance is -413321 million. City General Insurance gets first position in insurance sector of Bangladesh. The net income of City General Insurance is 59,397,666 million. Central insurance get last positions in insurance sector of Bangladesh. The net income of Central Insurance is 65112 million. United India Insurance gets first position in insurance sector of India. The net income of United India Insurance is 8228449 million. Bharti AXA Insurance gets last position in insurance sector of India. The net loss of Bharti AXA Insurance is -1422620 million. People Insurance gets first position in insurance sector of Srilanka. The net income of People Insurance is 1200240787million. Amana Takaful Insurance gets last position in insurance sector of Srilanka. The net income of Amana Takaful Insurance is -49559121 million.

⁷ This research is totally base on ratios. For this purpose we collected data from Balance sheet and Income sheet (2010) of different insurance companies of Pakistan and IAP. DuPont equation is a combination of income statement and balance sheet item.

⁸ All insurance companies of Pakistan are including in this research but for India, Bangladesh and Srilanka those companies are include which data are available on website.

Table-1: Ranking before DuPont analysis				
Asian Insurance Sector				
S.No	Pakistan	Srilanka	India	Bangladesh
1	IGI Insurance	People Insurance LTD.	United India Insurance	City General Insurance
2	Adamjee Insurance	Co- operative Insurance	New India Assurance	Green Delta Insurance
3	Central Insurance	Srilanka Insurance Co.	ICICI Lombard	Pragati Insurance Co.
4	New Jubilee Ins.	Ceylino Insurance PLC	Bajaj Allianz	United Insurance Co.
5	Security Gen. Insc.	Aviva Insurance Co.	Export Credit Guarantee	Peoples Insurance Co.
6	Atlas Insurance	Janashakhi Insurance	IFFCO - TOKIO	Asia Pacific Co.
7	Habib Insurance **	Union Insurance	Royal Sundaram Alliance	Federal Insurance Co.
8	Premier Ins. **	Asian Alliance insurance	Shriram General Insurance	Agrani Insurance
9	United Ins.	Allianz Insurance LTD.	Tata AIG Co.	Bangladesh National
10	Century Insurance	MBSL Insurance CO.	Star Health and Allied	Eastern Insurance
11	New Hampshire Ins.	HNB Insurance Co.	Universal Sampo Co.	Desh General
12	Reliance Insurance	Amana Takafuk Ins.	Apollo Munich Health	Meghna Insurance Co.
13	Askari Gen. Insc.		Future Generali India	Central Insurance Co.
14	Alfalah Ins. Co		HDFC Ergo Co.	
15	Silver Star Insc.		Bharti AXA Co.	
16	Excel Insurance			
17	East West Insc.			
18	Capital Insurance			
19	PICIC Insurance			
20	Pakistan Gen. Ins.			
21	Asia Insurance			
22	Crescent Star			
23	Alpha Insurance			
24	Cooperative Ins.			
25	Agro Gen. Ins. Co.			
26	TPL Direct Ins.			
27	UBL Insurer			
28	Shaheen Insurance			
29	Saudi Pak Ins.			
30	Universal Ins.			
31	EFU Gen. Ins. Ltd.			

Source: Website of insurance companies

The table 2 tells us the ranking of insurance companies of Pakistan according to DuPont equation. Habib Insurance gets first position in insurance sector of Pakistan. The ROE of Habib Insurance is 37. Universal Insurance gets last position in insurance sector of Pakistan. The ROE of Universal Insurance is -37. Federal Insurance gets first position in insurance sector of Bangladesh. The ROE of Federal Insurance is 34.98. Central Insurance gets last position in insurance sector of Bangladesh. The ROE of Central Insurance is 1.74. Bajaj Allianz Insurance gets first position in insurance sector of India. The ROE of Bajaj Allianz is 34.83. Bharti AXA Insurance gets last position in insurance sector of India. The ROE of Bharti AXA is -42.58. Srilanka Insurance gets first position in insurance sector of Srilanka. The ROE of Srilanka

Insurance is 72.31. Amana Takaful Insurance gets last position in insurance sector of Srilanka. The ROE of Amana Takaful is -36.

Table-2: Ranking after DuPont analysis				
Asian Insurance Sector				
S.No	Pakistan	Srilanka	India	Bangladesh
1	Habib Insurance **	S rilanka Ins. Co.	Bajaj Allianz	Federal Insurance Co.
2	Atlas Insurance	Allianz Ansurance	Shriram General Insurance	United Insurance Co.
3	Silver Star Insc.	Ceylino Insurance PLC	Royal Sundaram Alliance	Green Delta Insurance
4	United Ins.	HNB Insurance Co.	United India Insurance	Agrani Insurance
5	New Jubilee Ins.	Asian Alliance insurance	IFFCO - TOKIO	Desh General Ins.
6	Askari Gen. Insc.	Janashakhi Insurance	ICICI Lombard	City General Ins.
7	Reliance Insurance	Aviva Insurance Co.	Export Credit Guarantee	Bangladesh National
8	Alfalah Ins. Co	Union Insurance	Tata AIG General Insurance	Peoples Insurance Co.
9	Central Insurance	People Insurancd	New India Assurance	Asia Pacific Co.
10	Century Insurance	Co- operative Ins.	Star Health and Allied	Meghna Insurance Co.
11	Excel Insurance	MBSL Insurance CO.	HDFC ERGO	Pragati Insurance Co.
12	IGI Insurance	Amana Takafuk	Universal Sampo	Eastern Insurance Co.
13	Premier Ins. **		Future Generali India	Central Insurance Co.
14	Security Gen. Insc.		Apollo Munich Health Ins.	
15	Adamjee Insurance		BHARTI AXA	
16	Crescent Star			
17	East West Insc.			
18	PICIC Insurance			
19	Capital Insurance			
20	Asia Insurance			
21	Pakistan Gen. Ins.			
22	Alpha Insurance			
23	Cooperative Ins.			
24	Agro Gen. Ins. Co.			
25	New Hampshire Ins.			
26	UBL Insurer			
27	EFU Gen. Ins. Ltd.			
28	TPL Direct Ins.			
29	Shaheen Insurance			
30	Saudi Pak Ins.			
31	Universal Ins.			

Source: Website of insurance companies

The starting 6 companies in Table 2 from Habib Insurance to Askari General Insurance ROE are greater than 15%⁹ in Pakistan. There is an acceptable rate for ROE. The other companies ROE is not in acceptable rage. The first position gets Habib insurance according to ROE. The score of Habib Insurance is 37.32%.Askari General Insurance gets sixth position according to ROE. The score of Askari General Insurance is 15.01%. You can also observe that IGI stand first according to Net Income but IGI has failed to occupy the acceptable position according to ROE. The starting 9 companies in Table 2 from Srilanka Insurance to People General Insurance ROE are

⁹ 15% of ROE is according to paper “Mihaela Herciu, Claudia Ogrian and Lucian Belascu (2011).

greater than 15% in Srilanka. The starting 2 companies in Table 2 from Bajaj Allianz to Shriram General Insurance ROE are greater than 15% in India. The starting 6 companies in Table 2 from Federal insurance to City General Insurance ROE are greater than 15% in Bangladesh.

There is positive relationship between all variables because theory shows positive relationship between net income, return on equity, return on asset and financial leverage.

Table 3: Impact of ROA and FL on ROE according to Pakistan

Variables	Coefficient	t-stats	Prob.
C	-4.561	-3.832	0.000
ROA	2.405	22.780	0.000
FL	0.660	4.650	0.000
Adj. R²	0.856		
D.W stats	1.8		
F-stats (Prob.)	260 (0.000)		

Source: Author Estimation

Table 3 explains the regression analysis of Pakistan. Result explains that higher profitable companies are not most fruitful for investor. ROA and FL is significantly impact the ROE. The value of adjusted R-square is 85.6%. This shows that this model is accurate. F value belongs to P value. The value of F is 260. This shows that the independent variable is describing the dependent variable in a good manner. The Sig is P value. The value of P is 0.000; this is less than 0.05 that is why our model is significant. The coefficient value of ROA is 2.405. This means that 1 unit of ROA increase, so ROE will increase 2.405. The coefficient value of financial leverage is 0.660. This means that 1 unit of ROE increase, so ROE will be increase 0.660.

Table 4: Impact of ROA and FL on ROE according to Srilanka

Variables	Coefficient	t-stats	Prob.
C	-6.689	-1.736	0.092
ROA	3.729	15.969	0.000
FL	1.620	2.941	0.000
Adj. R²	0.879		
D.W stats	1.86		
F-stats (Prob.)	128 (0.000)		

Source: Author Estimation

Table 4 explains the regression analysis of Sri Lanka. Result explains that higher profitable companies are not most fruitful for investor. ROA and FL is significantly impact the ROE. The value of adjusted R-square is 87.9%. This shows that this model is accurate. F value belongs to P value. The value of F is 128. This shows that the independent variable is describing the dependent variable in a good manner. The Sig is P value. The value of P is 0.000; this is less than 0.05 that is why our model is significant. The coefficient value of ROA is 3.729. This means that 1 unit of ROA increase, so ROE will increase 3.729. The coefficient value of financial leverage is 1.620. This means that 1 unit of ROE increase, so ROE will increase 1.620.

Table 5 Impact of ROA and FL on ROE according to India

Variables	Coefficient	t-stats	Prob.
C	-2.597	-1.085	0.284
ROA	2.225	12.767	0.000
FL	0.970	2.642	0.012
Adj. R²	0.857		
D.W stats	1.81		
F-stats (Prob.)	132 (0.000)		

Source: Author Estimation

Table 5 explains the regression analysis of India. Result explains that higher profitable companies are not most fruitful for investor. ROA and FL is significantly impact the ROE. The value of adjusted R-square is 85.7%. This shows that this model is accurate. F value belongs to P value. The value of F is 132. This shows that the independent variable is describing the dependent variable in a good manner. The Sig is P value. The value of P is 0.000; this is less than 0.05 that is why our model is significant. The coefficient value of ROA is 2.225. This means that 1 unit of ROA increase, so ROE will increase 2.225. The coefficient value of financial leverage is 0.970. This means that 1 unit of ROE increase, so ROE will increase 0.970.

Table 6: Impact of ROA and FL on ROE according to Bangladesh

Variables	Coefficient	t-stats	Prob.
C	2.384	1.234	0.225
ROA	1.095	6.246	0.000
FL	0.845	6.670	0.000
Adj. R ²	0.633		
D.W stats	1.59		
F-stats (Prob.)	33.756 (0.000)		

Source: Author Estimation

Table 6 explains the regression analysis of Bangladesh. Result explains that higher profitable companies are not most fruitful for investor. ROA and FL is significantly impact the ROE. The value of adjusted R-square is 63.3%. This shows that this model is accurate. F value belongs to P value. The value of F is 33.756. This shows that the independent variable is describing the dependent variable in a good manner. The Sig is P value. The value of P is 0.000; this is less than 0.05 that is why our model is significant. The coefficient value of ROA is 1.095. This means that 1 unit of ROA increase, so ROE will increase 1.905. The coefficient value of financial leverage is 0.845. This means that 1 unit of ROE increase, so ROE will increase 0.845.

5. CONCLUSION AND MANAGERIAL IMPLICATION

This research paper examines the impact of DuPont analysis on insurance sector of South Asian region. The basic purpose is that in many times investors do not prefer to highly profitable companies. For this mechanism we rank insurance companies firstly on Net income (Effect method)¹⁰ and Secondly through DuPont analysis (Effort method)¹¹. The mostly previous research tells us about effect method but we analysis the difference between effect and effort method. if we compare to IGI and Habib Insurance because IGI insurance gets first position according to profit as compare to Habib insurance gets first position according to DuPont equation. IGI insurance net income (836556) 395% is greater than Habib Insurance net Income (168482) as compare to Habib insurance ROE (37.22) 5.2 time greater than IGI ROE (7.22)

¹⁰ This method is also use Mihaela Herciu, Claudia Ogrian and Lucian Belascu (2011).

¹¹ This method is also use Mihaela Herciu, Claudia Ogrian and Lucian Belascu (2011).

according to Pakistan insurance industry. There is positive correlation between all variables because theory shows positive relationship between net income, return on equity, return on asset and financial leverage. After that we analyze the impact of Return on asset and financial leverage on Return on equity. . The regression analysis shows that dependent variable is significantly impact on independent variable. The result show that the Net Income is not up to the mark in the eyes of most researchers or investors. Profit method cannot good every time. That is why mostly investors use DuPont method for efficient ranking of company.

This paper advocates that ROA should be superior to 5% according to practiced investor. There is a tolerable rate for ROA. ROE should be greater than 15% according to practiced investor. There is a tolerable rate for ROE. ROE should be most important performance indicator for all investor because it is resultant from ROA, ROS, and profit margin. Firms or investors should prefer profitability ratios as compare to firm profit. Firms should use proper capital structure. (60:40) Firms should use asset and operation resource in an efficient manner from the help of profitability ratios. Debt should be increase, so equity shrinks, if company wants to improve ROE. ROA and ROS should be higher; the result of this action will be the company ROE and performance will improve. Investors or firms should prefer effort method as compare to effect method.

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